

Sixth Sense Update

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CAPITALS GAINS TAX: IMPACT ON MUTUAL FUNDS

The Finance Bill 2010 ended the Capital Gains Tax (CGT) exemption on investment in Securities. Subject to this Ordinance, a “gain arising on the sale of securities” will be liable to a tax in accordance with a predefined tax schedule.

The effect of the CGT on investors of mutual funds is still uncertain. According to the Finance Bill 2010, securities means “shares of a public company, vouchers of Pakistan Telecommunication Corporation, Modaraba Certificates or instrument of redeemable capital”. This definition is open to debate and various fund managers are still uncertain as to whether mutual funds fall subject to the CGT.

FBR is expected to issue a detailed paper on the modalities, procedure and incidence of CGT after the Finance Bill 2010 is approved by the parliament. In the meanwhile, we present our understanding of the related issues for mutual funds.

Effect on Mutual Funds

The Finance Bill 2010 clearly outlines CGT on equity investment held for less than one year. Due to the tax on equities, we understand that investment in an equity fund will also be liable to pay the CGT. However, the imposition of CGT on other categories, including Income and Money Market Funds is uncertain as the underlying assets (apart from TFCs) are not subject to CGT.

Long term investments should remain unaffected

Under the Finance Bill 2010, investments held for less than 6 months will be liable for a CGT of 10%, investment between 6 to 12 months will be subject to 7.5% CGT and investment over 12 months will be tax exempt. As outlined in the table below, the CGT will become more aggressive with the period of time. However capital gains are adjustable over the next five years. This implies that gains in one period could be offset with losses in another with the net effect resulting in a lower tax. Nonetheless, capital gains are treated as a separate block of income and are not adjustable against other forms of tax.

CGT Slabs for securities under Finance Bill 2010

Holding Period	Tax Year	Rate of Tax
Less than 6 months	2010	10.0%
	2011	10.0%
	2012	12.5%
	2013	15.0%
	2014	17.5%
	2015	17.5%
	2016	17.5%
6 to 12 months	2010	7.5%
	2011	8.0%
	2012	8.5%
	2013	9.0%
	2014	9.5%
	2015	10.0%
	2016	10.0%
Greater than 12 months		0.0%

Source: Budget documents, Sixth Sense Research

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Incidence of Taxation

In the event that mutual funds fall under CGT, the incidence of the tax plays an important role. The tax can either be levied directly on the mutual fund assets when securities are traded; or on the investor when units of the fund are redeemed.

We believe it is beneficial for the investor to bear the incidence of the tax. Firstly, an investor can control the holding period of his investment. Moreover by holding the investment for over 12 months, the investor can avoid any tax deductions while capitalizing on short term trading opportunities.

Tax Collection; AMCs not to act as collecting agents

In case CGT is levied at investor level (rather than direct levy on mutual funds), Asset Management Companies (AMCs) will not act as tax collection agents. Instead, the CGT will be collected when an individual files for taxes. An 'Advance Tax' clause highlights that taxpayers filing for quarterly taxes would be liable to a 2% CGT for securities held less than 6 months and a 1.5% CGT for a holding period of 6–12 months. The remaining burden of the CGT will be paid at the end of the fiscal year.

Investments made prior to July 2010 should remain tax exempted

Finance Bill 2010 will not specify a date after which the CGT will be applicable. However based on consensus achieved amongst the various stakeholders in Feb10, we understand that CGT will be applicable only for purchases made after July 1, 2010. Therefore, purchases made up till June 30, 2010 would be exempt from CGT irrespective of the date of disposal.

Comparing with regional markets

Various foreign markets have a capital gains tax imposed on gains from investments in equities and mutual funds. India, for instance, is subject to a CGT of 10% for investments made for less than one year. Investments held for more than a year are exempt from taxes. The US and China follow tax schedules based on income levels and residence status. Malaysia and Singapore, on the other hand, do not have a CGT on investment in securities.

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